Pairing Taxable GNMA Loans with Tax-Exempt Bonds
Maryland Department of Housing and Community Development

Updated Guidance
February 7, 2013 (supersedes and replaces the June 2011 guidance)

On June 29, 2011, the Maryland Department of Housing and Community Development ("DHCD") issued a guidance memo regarding a new financing technique to be used to facilitate multifamily rental development activity that includes tax-exempt housing revenue bonds (the "Bonds") and 4% Low Income Housing Tax Credits (the "Tax Credits"). The financing technique enables qualified multifamily rental housing developments to realize the lower interest rates associated with taxable GNMA loan executions (the "GNMA Loan") in conjunction with the Tax Credits available with tax-exempt bond issuances ("Tax/TE Financing").

This February 7, 2013 Guidance memo updates and replaces the June 29, 2011 memo. It provides substantial additional detail concerning the Tax/TE Financing and will govern all transactions effective with its issuance. It is intended to respond to additional information learned as DHCD worked through its first Tax/TE Financings and to make comprehensive changes at one time to ensure DHCD meets its rental housing goals, including full implementation of Rental Housing Works (RHW).

Background

DHCD originally offered this Tax/TE Financing as a new product to provide a strong financial alternative to traditional tax -exempt bonds and reduce borrowing costs in order to minimize subsidies and maximize leverage. In September 2012, DHCD closed its first transaction using the Tax/TE Financing and, in February 2013, expects to close three additional transactions. As DHCD worked through these four transactions with the borrowers and other lenders and attorneys, a number of issues arose that demonstrated the need to update the June 29, 2011 guidance. These issues concern the amount of taxable and tax-exempt loan amounts, bankruptcy risk, and the placement, credit enhancement and rating of the bonds.

DHCD's first execution of the Tax/TE Financing was accomplished through a private placement of unrated Bonds. The decision to pursue unrated, private placement was predicated on the increased cost to the borrower associated with obtaining the necessary bankruptcy opinions required by the bond rating agency in connection with the proposed funding structure. Therefore, in order to continue to preserve the financial benefits of the Tax/TE Financing, DHCD has determined that Tax/TE Financing will be accomplished by the private placement of unrated bonds. Sections A, B, and C below provide further details.

Several borrowers had requested that DHCD permit the issuance of tax-exempt bonds in amounts necessary to meet the 50% test for Tax Credits, but which amount may be less than the GNMA Loan. DHCD declined to accept this type of funding proposal and in its June 2011 Guidance, required the tax-exempt bonds be issued for the same amount as the GNMA Loan. However, as projects and their financial needs are considered and reviewed, DHCD recognizes that this requirement can have the effect of making some projects financially infeasible by forcing on the project the burden of costs associated with higher than necessary tax-exempt bond amounts. Additionally, after DHCD worked through the administrative issues and funding mechanics associated with permitting a tax-exempt bond amount in excess of the GNMA Loan, it was able to address the reverse funding structure – the tax-exempt bond amount which is less than the GNMA Loan. The flexibility to structure the bond financing either way provides financial benefits to some projects, furthers the original goals of the Tax/TE Financing, and is administratively manageable by DHCD. Thus, Section D below now permits mismatches in the amounts of the GNMA Loan and tax-exempt loans.

Updated Guidance

A) Unrated Private Placement of the Bonds: DHCD anticipates most future Tax/TE Financing will require the issuance of unrated Bonds. Project sponsors using unrated Bonds must choose an entity to purchase the unrated Bonds. When this structure is used, the following conditions must be met to DHCD's sole satisfaction:

1) the entity purchasing the Bonds must be approved by DHCD;

2) the entity purchasing the Bonds must agree to retain the Bonds and not sell, hypothicate, transfer or otherwise dispose of ownership or control of the Bonds in any way, shape or form for the entire term of the Bonds;

3) the interest rate agreed to on the Bonds must be approved by DHCD to ensure the rate is competitive in the tax-exempt bond market;

4) Any relationship between the purchaser of the Bonds and the investor in the Tax Credits must not trigger the "substantial user" requirements of the Federal Tax Code. For transactions with such a possible relationship (as determined in DHCD's sole discretion) the borrower must provide a letter from qualified legal counsel (acceptable to DHCD in its sole discretion) opining that the "substantial user" issue has not been triggered; and

5) The entity purchasing the Bonds must accept all possible risks that may result from the borrower becoming insolvent and/or bankrupt, and must execute an investor letter addressed to DHCD prior to its purchase of the

Bonds. In the investment letter the entity must acknowledge, among other things, that (i) the entity has sufficient knowledge and experience in business and financial matters in general, and investments such as the Bonds in particular, and therefore is capable of evaluating the merits and risks involved in an investment in the Bonds, and (iii) the entity is able to bear the economic risk, including an entire loss, of an investment in the Bonds.

Please note: the issuance of unrated, privately placed bonds is not DHCD's normal business practice, and the above-referenced structure is permitted only for projects making use of the financing technique outlined in this memo.

B) Rated Bond Transaction: A rated bond transaction will be required if (i) a borrower is unable to find an entity to purchase the Bonds as an unrated placement, or (ii) if CDA, working with its investment bankers and financial advisors, determines that a rating on the Bonds will be required to sell the Bonds at an acceptable interest rate as determined in DHCD's sole discretion. In either event CDA will require that the transaction be structured as a draw down loan and a bankruptcy opinion will be required that meets the requirements of Moody's. The borrower must agree to pay the cost of the bankruptcy opinion, which is estimated to be approximately $10,000 to $15,000.

With a rated bond transaction, the following three additional conditions must be met in order to meet the requirements of the bankruptcy opinion:

1) the borrower will not be entitled to any residual amounts on deposit in the Bond indenture accounts covered by the bankruptcy opinion;

2) the borrower will not be entitled to collect or receive credit for excess investment earnings on the Bond indenture accounts covered by the bankruptcy opinion; and

3) The borrower will not be permitted to direct the investment of the funds held in the Bond indenture accounts covered by the bankruptcy opinion.

C) Unrated/Rated Transaction at DHCD's Discretion: In some instances, investors may be willing to purchase the Bonds without a bankruptcy opinion, but only if the additional three requirements outlined in paragraph B above are present. In such circumstances DHCD, in its sole discretion, may (i) choose to proceed as an unrated transaction and therefore not require a bankruptcy opinion, or (ii) may proceed as a rated transaction and therefore require a bankruptcy opinion, the cost of which shall be paid by the borrower.

D) DHCD Bond Issuance Amount: The taxable and tax-exempt loan amounts may differ. At all times, the tax-exempt bond proceeds must be sufficient to satisfy the 50% test for Tax Credits and the full amount of the tax-exempt bond amount must be secured 100% by cash collateral. A Letter of Credit is not sufficient.

E) DHCD Underwriting Guidelines: Financing requires HUD/GNMA credit enhancement via 221(d), 220, etc. A MAP Lender must be engaged by the borrower. FHA Risk Share via DHCD is not eligible since GNMA securitization of loan is required.

Applicants should use the following standards in structuring project sources and uses for DHCD financing application.

Taxable Interest Rate:	Interest rate guidance may be obtained by contacting the individuals listed at the bottom of this memo. DHCD cannot guarantee interest rates, and any interest rate guidance provided by DHCD is for informational purposes only and should not be relied upon or considered binding in any manner. The June 2011 guidance estimated the rate at 5.25% and currently, rates are significantly lower, estimated at 3.3% for January 2013.
Loan Term/Amortization:	40/40. Up to 24 month construction period. Interest-only payments during construction.
Negative Arbitrage:	Budget 2.7% of the tax-exempt loan amount. This budget amount could increase if rates increase. Tax-exempt bonds will be issued in short-term maturities (24-36 months), thereby limiting, but not entirely eliminating, negative arbitrage. Allowance of 2.7% covers a total of 2 years of negative arbitrage (1.35% per year) based on estimated differential between short-term tax-exempt bond rate and reinvestment rate.. As comparison, negative arbitrage for conventional tax-exempt issuance would be 3 to 4 times higher. Actual negative arbitrage will be based on final pricing of tax-exempt bonds.
Fees:	**Taxable HUD/GNMA Loan** -- Normal fees apply. Consult a MAP lender for detail. **DHCD Tax-Exempt Loan** – Normal DHCD fees associated with tax-exempt financing apply (see Exhibit B, Multifamily Rental Financing Program Guide) with the following exceptions:

1) DHCD Up-front Commitment/Origination Fee – 3%. Increased from 1.5% normal fee due to short-term nature of financing.

2) DHCD Override – There is no add-on by DHCD to the taxable GNMA loan. The normal 25 basis point override will be added to the interest rate on the short-term tax-exempt bonds, which is included in the negative arbitrage allowance detailed above.

Tax Credit Percentage: Projects which propose using the 4% Low Income Housing Tax Credit are subject to risk associated with monthly changes to the Tax Credit Percentage. The January 2013 Tax Credit Percentage is 3.16%

F) Purpose of Guidance Memo: This guidance memo is being provided as a service to our partners to facilitate multifamily rental development activity, and DHCD reserves the right, in its sole discretion, not to offer the financing technique discussed herein, or to modify it in whole or in part, at any time.

DHCD Multifamily staff is available to meet with prospective borrowers to answer any questions as needed. Please contact:

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H:bond issues/GNMA Matters